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In the Supreme Court of the United States

OCTOBER TERM, 1957

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

NEIL SULLIVAN AND GRACE SULLIVAN; JAMES ROSS AND ANN ROSS; SAM MESI

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE PETITIONER

J. LEE RANKIN,
Solicitor General,
CHARLES K. RICE,
Assistant Attorney General,
JOSEPH F. GOETTEN,
MEYER ROTHWACKS,
Attorneys,
Department of Justice, Washington 25, D. C.

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OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court in the *Sullivan* and *Ross* cases (R. 5–16) are not officially reported; the opinion of the Court of Appeals (R. 20–22) is reported at 241 F. 2d 46. The Tax Court's findings of fact and opinion in the *Mesi* case (R. 81–95) are reported at 25 T. C. 513; the opinion of the Court of Appeals (R. 98–100) is reported at 242 F. 2d 558.

JURISDICTION

The judgments of the Court of Appeals in the *Sullivan* and *Ross* cases (R. 22–23) were entered on February 13, 1957. The judgment of the Court of

Appeals in the *Mesi* case (R. 100-101) was entered on April 5, 1957. The petition for a writ of certiorari, filed on May 9, 1957, was granted on June 17, 1957. (R. 101.) The jurisdiction of this Court rests upon 28 U. S. C. 1254.

QUESTION PRESENTED

Whether amounts expended to lease premises and hire employees for the conduct of illegal gambling enterprises were deductible as ordinary and necessary business expenses within Section 23 (a) (1) (A) of the Internal Revenue Code of 1939, where the expenditures themselves constituted violations of the criminal statutes of the State of Illinois and were made for the purpose of inducing others to violate the law.

STATUTES INVOLVED

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [as amended by Sec. 121 (a), Revenue Act of 1942, c. 619, 56 Stat. 798, 819] *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *, and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property

to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

(26 U. S. C. 1952 ed., Sec. 23 (a).)

Illinois Revised Statutes (1945), c. 38 (Criminal Code):

GAMBLING AND GAMBLING DEVICES

336. *Book-making and pool-selling unlawful.* § 1. * * * That any person who keeps any room, shed, tenement, tent, booth, or building, or any part thereof, or who occupies any place upon any public or private grounds within this state, with any book, instrument or device for the purpose of recording or registering bets or wagers, or of selling pools, or any person who records or registers bets or wagers, or sells pools upon the result of any trial or contest of skill, speed or power of endurance of man or beast, or upon the result of any political nomination, appointment or election, or being the owner, lessee or occupant of any room, shed, tenement, tent, booth, or building, or part thereof, knowingly permits the same to be used or occupied for any of these purposes, or therein keeps, exhibits or employs any device or apparatus for the purpose of recording or registering such bets or wagers, or selling of such pools, or becomes the custodian or depository for hire or privilege, of any money, property, or thing of value staked, wagered or pledged upon any such result, shall be punishable by imprisonment in the county jail for a period not longer than one year or by fine not exceeding $2,000 or both. * * *

ACCESSORIES

582. *Before the fact.* § 2. An accessory is he who stands by, and aids, abets or assists, or who not being present, aiding, abetting or assisting, hath advised, encouraged, aided or abetted the perpetration of the crime. He who thus aids, abets, assists, advises or encourages, shall be considered as principal, and punished accordingly.

STATEMENT

Sullivan and Ross. During 1948, 1949 and 1950, the taxpayers, Neil Sullivan and James Ross,[1] were equal partners in a bookmaking establishment in Chicago, Illinois, which was engaged in accepting wagers on horse races. (R. 7–8.) The enterprise was illegal under the Criminal Code of Illinois. (R. 15, 21.)

The partnership claimed deductions for the following amounts of wages and rent paid during the years involved (R. 11):

Year	Wages	Rent
1948	$15,750	$8,735
1949	20,938	9,200
1950	24,050	9,215

The services for which the wages were paid to the six or seven employees of the partnership were performed in the operation of the bookmaking business, including the recording of bets. (R. 11.)

The activities of the partnership were conducted in various leased rooms in the upper floors of a hotel located in the central business district of Chicago.

[1] Grace Sullivan and Ann Ross are taxpayers because they filed joint returns with their husbands.

Because of frequent police raids, the partnership changed its rooms at the hotel from time to time. The lessor knowingly permitted the rooms to be used for bookmaking purposes. (R. 7, 9–11.)

The Tax Court found that the acts performed by the employees of the partnership in return for their wages, and by the lessor in return for the rents paid, constituted violations of Section 330 of the Criminal Code of the State of Illinois. It also found that the payment of the wages and rents by the taxpayer constituted a violation of Section 582 of that Code. (R. 11.)

The Tax Court held that to allow the amounts so paid to be deducted from gross income would constitute a clear violation of public policy, since it would permit the deduction of expenditures, the making of which constituted illegal acts. Accordingly, it held that the deductions should be disallowed. (R. 15–16.)

The Court of Appeals, on the authority of its prior holding in *Commissioner* v. *Doyle*, 231 F. 2d 635, reversed the judgment of the Tax Court.[1] It remanded the cause solely for the redetermination of an issue not before this Court. (R. 21–22.)

Mesi. During the year 1946, the taxpayer was engaged in accepting wagers on horse races, commonly known as bookmaking. He had a principal location from which he operated his gambling business, but compelled to move about because of raids by the police, he operated from three or four different lo-

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[1] The decisions below in the instant cases followed the result of the *Doyle* case, and, for the Court's convenience, the *Doyle* opinion is reproduced in the Appendix, *infra*, pp. 22a–24a.

cations during 1946, including a garage, basements, hallways and alleyways. His activities were extensive. Although the great majority of the bets taken were small—for 50 cents, $1, or $2—and no bets in excess of $100 were accepted, incoming bets totaled $793,287.50 in 1946. (R. 82–83.)

The taxpayer spent little time at his establishment during the daytime, occasionally visited it in the afternoons, and usually went there in the evenings when the summaries of the day's activities were being prepared. During 1946, he employed six or seven persons, including a cashier, two or three sheet writers who accepted and entered the incoming bets, men on the "hard cards,"[3] and a doorman. He paid these employees gross wages, aggregating $14,563.84, which the Commissioner disallowed as a deduction. (R. 83, 90.)

The Tax Court found that the services which the employees had performed constituted a violation of Section 336 of the Criminal Code of the State of Illinois, and that the payment of the wages, in and of itself, constituted an illegal act. Accordingly, it held that the deduction for the wages paid had been properly disallowed for the reason that "it would be a clear violation of public policy to permit the deduction of an expenditure, the making of which constitutes an illegal act." (R. 86, 93.)

The Court of Appeals, relying upon its prior decisions in the *Doyle* case (Appendix, *infra*, pp. 39–46)

[3] The "hard cards" were large cardboard sheets, one for each track, which showed the entries for the day, the jockey, and the probable odds. (R. 83.)

and in the *Sullivan* and *Ross* cases (R. 20–22), reversed the judgment of the Tax Court and remanded the case for further proceedings with respect to an issue not raised here (R. 100–101).

SUMMARY OF ARGUMENT

I

The amounts which the taxpayers seek to deduct as "ordinary and necessary" business expenses were payments that were illegal under Illinois law, independent of the fact that they were engaged in an illegal business. The Illinois statute makes it a crime for an owner of a building knowingly to allow someone to use the premises for a bookmaking establishment. The expenditures which the taxpayers seek to deduct as "rent" were payments made to a hotel to induce the hotelkeeper to commit that crime.

Similarly, the "wages" paid to those who worked at the bookmaking establishment were illegal, not because the taxpayers were engaged in an illegal enterprise but because the payments were themselves made to bring about the commission of additional crimes. The Illinois statute makes it a crime to record or register bets as well as to aid and abet the running of a gambling establishment. The payments to their associates which the taxpayers seek to deduct were the very payments used to induce those persons to commit crimes. The payments here in question are thus unlike other expenditures of a bookmaking enterprise, such as for paper and pencils, gasoline for the cars, etc., which it may not be a crime to make and which do not induce other persons to commit a crime.

There is a general rule accepted by this Court and applied in a great many cases that what constitutes an "ordinary and necessary" business expense must be determined in the light of state and federal legislation which may make certain conduct or expenditures illegal. Frequently referred to as a "public policy" limitation, the principle is really one of statutory construction. This Court has held that business expenses "arising from that family of contracts to which the law has given no sanction" need not be considered as "ordinary and necessary." *Textile Mills Corp.* v. *Commissioner*, 314 U. S. 326, 339. In *Commissioner* v. *Heininger*, 320 U. S. 467, 473–474, and in *Lilly* v. *Commissioner*, 343 U. S. 90, 96–97, the Court indicated a rule of nondeductibility in those situations in which the allowance of a deduction "would frustrate the sharply defined policies" by which the federal or state government proscribed "particular types of conduct."

This rule has been applied in a large number of cases. Payments for lobbying activities were disallowed in the *Textile Mills* case. Bribes have regularly been disallowed on the theory that they are illegal and that no matter how "ordinary" they are they cannot be held to be "necessary." Similarly, where the expense was incurred as legal fees in defense of criminal conduct it has been found not "ordinary and necessary" and hence nondeductible. Where wages [illegible] in excess of those legally allowed, [illegible] which it was illegal to make [illegible] nondeductible. Fines imposed for [illegible] have regularly been held not to be

deductible. In such cases the expenses are not "ordinary and necessary," for to allow deduction would frustrate public policy embodied in provisions of law.

II

The taxpayers' arguments in support of deductibility are without merit.

1. The taxpayers point to the fact that rentals and salaries are specifically mentioned in Section 23 (a) (1) (A) as being included within the class of ordinary and necessary business expenses. But salaries and rentals, like every other category of business expense, are deductible only if they are "ordinary and necessary." A business cannot deduct compensation paid for personal services unless those services are an ordinary and necessary part of the business. But bribes, the classic example of nondeductible expense, are payments for services. Payments made to lawyers in defense of criminal charges and wages in excess of statutory ceilings are other examples of personal compensation to which the public policy rule has properly been applied. The fact that personal compensation and rentals are specifically listed in Section 23 (a) (1) (A) does not make them immune from the test of "ordinary and necessary", which implicitly excludes "unlawful".

2. The taxpayers argue that Congress has manifested an intent that illegal enterprises should be allowed to deduct all of their expenses. The "legislative history" relied upon is the defeat of a proposal [illegible] Senator Byrd's amendment in 1951 under which "any expenses incurred in illegal wagering" would have

been disallowed as a deduction. But this argument is not persuasive. Congressional inaction in 1951 does not prove Congressional intent in 1939. Further, the 1951 proposal did not deal with the issue whether payments which are illegal in themselves were ordinary and necessary; the proposal was rather that *all* expenses incurred in one particular line of illegal activity, namely, illegal wagering, be made nondeductible. Finally, the proposal was only one of a package including a number of other measures directed at wagering houses, such as the filing of net worth statements, keeping of records, etc. The failure of Congress to accept this proposal does not reflect any purpose that all so-called business expenses which are themselves illegal are to be treated differently when made by persons engaged in an illegal enterprise than when made by persons engaged in a lawful business.

3. Disallowance of the deductions here involved does not mean, as the taxpayers contend, that they are being taxed on their gross income. The payments for rent and wages, in the circumstances of these cases, constituted crimes under the Illinois laws; for that reason, the expenditures could not qualify as "ordinary and necessary" within the meaning of Section 23 (a) (1) (A). The taxpayers would be entitled to deductions for any other expenses which could so qualify.

4. The court below held that expenditures are deductible, no matter how illegal they may be, if they are "economically * * * an integral part of a business." This criterion of deductibility finds no support in the statute. In addition to being too vague

and confusing for practical application, it is irreconcilable with the body of decisions construing Section 23 to preclude deduction of expenses which frustrate defined public policy. Expenditures made to induce commission of crimes, and which are *per se* illegal under state law, clearly fall within that category.

ARGUMENT

I. THE PAYMENTS WHICH TAXPAYERS SEEK TO DEDUCT WERE INDEPENDENTLY ILLEGAL UNDER ILLINOIS LAW AND WERE MADE TO INDUCE OTHERS TO COMMIT CRIMES. ACCORDINGLY, THEY DO NOT QUALIFY FOR DEDUCTION AS "ORDINARY AND NECESSARY" BUSINESS EXPENSES UNDER SECTION 23 (a) (1) (A).

The taxpayers in these three consolidated cases were engaged in bookmaking, an illegal enterprise in the State of Illinois. (R. 7, 15, 82–83; Section 336, Illinois Criminal Code, *supra*, p. 3.) During the years in question the taxpayers in the *Sullivan* and *Ross* cases took deductions for rents paid to lessors who knew that the premises were to be used for the proscribed criminal activity (R. 11), and the taxpayers in the *Sullivan*, *Ross* and *Mesi* cases took deductions for wages paid to their respective employees for services performed in the illegal operation of the ventures, including the recording of bets (R. 11, 90). The Tax Court determined that the payments of rents and wages were, in and of themselves, violations of the Illinois Criminal Code and of a clearly defined and declared public policy of that State. (R. 11, 15, 86, 93.) Accordingly, it held that the amounts paid were not deductible for income tax purposes. The Court of Appeals reversed. Ad-

verting to its rationale in *Commissioner* v. *Doyle* (Appendix, *infra*, pp. 39–46), it held, in effect, that despite their illegality the amounts paid were deductible as "integral" expenses of the business in which taxpayers were engaged.

The instant cases thus present the question whether such expenditures, the making of which was in violation of state law, are deductible from gross income as "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business" (Section 23 (a) (1) (A) of the Internal Revenue Code of 1939, *supra*, p. 2). The question, as well as its possible resolution, has not been unanticipated by this Court. In *United States* v. *Sullivan*, 274 U. S. 259, 264, the Court, in an opinion by Mr. Justice Holmes, replying to a suggestion that one engaged in the illicit traffic of liquor might be entitled to deduct illegal expenses such as bribery, stated: "This by no means follows, but it will be time enough to consider the question when a taxpayer has the temerity to raise it." In *Textile Mills Corp.* v. *Commissioner*, 314 U. S. 326, 339, this Court found that under the statutory standard of "ordinary and necessary" a line could be drawn "between legitimate business expenses and those arising from that family of contracts to which the law has given no sanction." In *Commissioner* v. *Heininger*, 320 U. S. 467, 473–474, this Court suggested a rule of nondeductibility in those situations in which the allowance of a deduction "would frustrate the sharply defined policies" by which the federal or state governments proscribed "particular types of conduct," a rule which was sub-

sequently reiterated in *Lilly* v. *Commissioner*, 343 U. S. 90, 97:

> The policies frustrated must be national or state policies evidenced by some governmental declaration of them.

In the *Lilly* case, hypothesizing the factual situation presented by the instant cases, this Court observed (pp. 94–95):

> We do not have before us the issue that would be presented by expenditures which themselves violated a federal or state law or were incidental to such violations. In such a case it could be argued that the outlawed expenditures, by virtue of their illegality, were not "ordinary and necessary" business expenses within the meaning of § 23 (a) (1) (A).

This is such a case, and the Government makes that argument now. We emphasize at the outset that this case does not involve a type of expenditure which would be any more deductible if it were made by a taxpayer engaged in a lawful rather than an unlawful business. Nor are we contending that Congress intended to tax the gross income of one business and the net income of another. Rather, the expenditures here—being illegal in themselves and, in fact, payments for the commission of crimes—would not be deductible by a taxpayer engaged in a legitimate business. They should, we submit, be treated no differently or more favorably merely because the taxpayers seeking to deduct them are engaged in an illegitimate business. We contend not that Congress

intended to levy a tax on the gross income of illegal businesses, but rather that, in providing that only "ordinary and necessary" expenses should be allowed as deductions in computing the taxable income of any business, Congress established a standard of deductibility which is not satisfied here, for in no sense can an expenditure to commit crime, illegal under applicable state law, be regarded as an "ordinary and necessary" expense of a business, whether the enterprise be legitimate or otherwise.

I. IN GENERAL: THE "PUBLIC POLICY" RULE

There is a well-established rule of construction of Section 23 (a) (1) (A) that it does not permit the deduction as "ordinary and necessary" of various expenditures where to do so would frustrate sharply defined public policies, as embodied in state and federal legislation.* Neither the judicial nor administrative practice has been uniformly consistent in the application of the principle, but its existence cannot be doubted.

The allowance of a deduction "depends upon legislative grace," and "only as there is clear provision therefor can any particular deduction be allowed." *New Colonial Co.* v. *Helvering*, 292 U. S. 435, 440; *White* v. *United States*, 305 U. S. 281, 292; *Deputy* v. *duPont*, 308 U. S. 488, 493; *United States* v. *Olympic Radio and Television*, 349 U. S. 232. Section 23 (a) (1) (A) does not authorize the deduction of every

* These cases arise under the Internal Revenue Code of 1939, and we refer throughout to Section 23 (a) (1) (A) of that Code. The issue is of continuing importance since Section 162 (a) of the 1954 Code contains similar language.

business expense incurred or paid during the taxable year. In order to be deductible, the expense must be "ordinary and necessary." The phrase is in the conjunctive, and both requirements must be satisfied. *Deputy* v. *duPont*, *supra*, 308 U. S. at 497; *Welch* v. *Helvering*, 290 U. S. 111, 113. Expenditures are not deductible simply because they were made in connection with an income-producing activity. *Welch* v. *Helvering*, *supra*; *Great Northern Ry. Co.* v. *Commissioner*, 40 F. 2d 372, 373 (C. A. 8th), certiorari denied, 282 U. S. 855; see also, *Clarke* v. *Haberle Brewing Co.*, 280 U. S. 384, 386–387, and *Ronziehausen* v. *Lucas*, 280 U. S. 387. "It would be an anachronism to say that * * * an act, so inimical to the public interest as to justify punishment for its commission, may at the same time be so recognized that the expense involved in its commission is sanctioned by the revenue law as an ordinary and necessary expense of carrying on a business." *Backer* v. *Commissioner*, 1 B. T. A. 214, 216. By this test, "it is not conceivable that Congress intended that section 23 (a), allowing deductions for business expenses, should be a medium for giving the benefits thereof directly or indirectly * * * where the expenditures are made to others in compensation to them for unlawful activities." *Silberman* v. *Commissioner*, 44 B. T. A. 600, 604 (deductions denied to New York bookmaker for the payments of rents and wages which were crimes under the New York statutes). Cf. *Ellery* v. *Commissioner*, 4 T. C. 407, 414. See also, *National Brass Works* v. *Commissioner*, 182 F. 2d 526, 530–531 (C. A. 9th); *New Orleans Tractor Co.* v. *Commissioner*, 35 B. T. A. 218, 226; *Anderson* v. *Com-*

missioner, 35 B. T. A. 10, 12; *Terminal Railroad Assn. of St. Louis* v. *Commissioner*, 17 B. T. A. 1435, affirmed, *sub nom. Tunnel R. R. v. Commissioner*, 61 F. 2d 166, 174 (C. A. 8th), certiorari denied, 288 U. S. 604, 607.

Although the language of Section 23 (a) (1) (A) "contains no express reference to the lawful or unlawful character of the business expenses which are declared to be deductible" (*Commissioner* v. *Heininger, supra*, 320 U. S. at 474), the words "ordinary and necessary" clearly carry such an implication. An expenditure, the making of which involves the commission of a crime, cannot be regarded as "ordinary and necessary" in any reasonable sense of those words. It was not necessary for Congress expressly to add the adjective "lawful", since it is plainly implied by, and comprehended within, the words "ordinary and necessary". Certainly Congress cannot be presumed to have regarded payments for the performance of a criminal act as other than extraordinary and unnecessary. In the *Textile Mills* case, *supra*, in upholding the validity of an interpretative regulation defining the words "ordinary and necessary" as excluding certain types of lobbying expenses, this Court said (pp. 338–339):

> The words "ordinary and necessary" are not so clear and unambiguous in their meaning and application as to leave no room for an interpretative regulation. The numerous cases which have come to this Court on that issue bear witness to that. *Welch* v. *Helvering*, 290 U. S. 111; *Deputy* v. *duPont*, 308 U. S. 488, and cases cited. Nor has the administrative agency

usurped the legislative function by carving out this special group of expenses and making them non-deductible. We fail to find any indication that such a course contravened any Congressional policy. Contracts to spread such invidious influences through legislative halls have long been condemned. *Trist* v. *Child*, 21 Wall. 441; *Hazelton* v. *Sheckells*, 202 U. S. 71. Whether the precise arrangement here in question would violate the rule of those cases is not material. The point is that the general policy indicated by those cases need not be disregarded by the rule-making authority in its segregation of non-deductible expenses. There is no reason why, in absence of clear Congressional action to the contrary, the rule-making authority cannot employ that general policy in drawing a line between legitimate business expenses and those arising from that family of contracts to which the law has given no sanction. The exclusion of the latter from "ordinary and necessary" expenses certainly does no violence to the statutory language. The general policy being clear it is not for us to say that the line was too strictly drawn.

The drawing of a line between permissible deductions and those expenditures which are not "ordinary and necessary" within the meaning of the statute is not the exclusive function of administrative interpretation. The lower courts have held—in many decisions applying the principles stated in the *Textile Mills* case, but not resting upon the language of any regulation—that, in circumstances where the expenditures violate declared public policy, they are not to be treated as "ordinary and necessary" in the

statutory context "as a matter of law" (*Lilly v. Commissioner, supra*, 343 U. S. at 97). "The Bureau of Internal Revenue, the Board of Tax Appeals, and the federal courts have from time to time, * * * narrowed the generally accepted meaning of the language used in § 23 (a) in order that tax deduction consequences might not frustrate sharply defined national or state policies proscribing particular types of conduct" (*Commissioner* v. *Heininger, supra*, 320 U. S. at 473); "in the nature of things public policy must narrow the field of allowable deductions which rest as they do upon legislative indulgence" (*National Brass Works* v. *Commissioner, supra*, 182 F. 2d, at 530).

The concept that the deductibility of business expenses is subject to an overriding public policy limitation has been applied by the lower courts in a variety of circumstances; indeed, so extensively as to cause this Court to comment that "A review of the situations which have been held to belong in this category would serve no useful purpose for each case should depend upon its peculiar circumstances." *Commissioner* v. *Heininger, supra*, 320 U. S. at 473.[*] Citing examples

[*] For a collection and analysis of many of the cases, see 4 Mertens, *Law of Federal Income Taxation* (Rev.), Sections 25.131-25.135; Paul, *The Use of Public Policy by the Commissioner in Disallowing Deductions*, So. Cal. Tax Institute (1951), p. 215; Lurie, *Deductibility of "Illegal" Expenses*, Eleventh Annual N. Y. U. Institute on Federal Taxation (1952), p. 1189; Schwartz, *Business Expenses Contrary to Public Policy: An Examination of the "Illegal Expense"*, 8 Tax L. Rev. 241 (January, 1953); Brookes, *Litigation Expenses and the Income Tax*, 12 Tax L. Rev. 241, 263-273 (March, 1957); 27 A. L. R. 2d 503, 536.

to illustrate the principle involved, this Court said (*Heininger, supra*, pp. 473–474):

> Where a taxpayer has violated a federal or a state statute and incurred a fine or penalty he has not been permitted a tax deduction for its payment. Similarly, one who has incurred expenses for certain types of lobbying and political pressure activities with a view to influencing federal legislation has been denied a deduction. And a taxpayer who has made payments to an influential party precinct captain in order to obtain a state printing contract has not been allowed to deduct their amount from gross income.

The illustrations were not intended to be, and are not, exhaustive. The cases in which the so-called public policy rule has been applied in denying deductions fall into several related and often overlapping groups.[6] One major group, comprising cases involving the payment of fines and penalties for violation of federal and state statutes, establishes that such payments, even though proximately connected with the taxpayer's business and, in some instances, even though inadvertent, unintentional or even unavoidable in the conduct of the taxpayer's business, are not deductible.[7] "The real reason for denying the deduct-

[6] See the categories suggested in 4 Mertens, *Law of Federal Income Taxation*, *supra*, Section 25.131, p. 276, and Schwartz, *Business Expenses Contrary to Public Policy: An Evaluation of the Lilly Case*, *supra*, p. 242.

[7] See, *e. g.*, *Bonnie Bros., Inc.* v. *Commissioner*, 15 B. T. A. 1231 (payment of fine for violation of federal laws regulating the interstate shipment of intoxicating liquors); *Kansas City Southern Ry. Co.* v. *Commissioner*, 22 B. T. A. 949 (payment of penalties for violation of federal statutes); *Achelis* v. *Com-*

bility of "penalties" is not that they are characterized as such but because allowance in many cases would be against public policy." *National Brass Works* v. *Commissioner*, *supra*, 182 F. 2d at 530. Manifestly, to the extent that allowance of a deduction constitutes a partial remission of fines or penalties by way of tax advantage, there is a frustration of the public policies against the proscribed activities, as embodied in the laws imposing the sanctions. Cf. *Jerry Rossman Corp.* v. *Commissioner*, 175 F. 2d 711 (C. A. 2d); *Commissioner* v. *Pacific Mills*, 207 F. 2d 177 (C. A. 1st); *National Brass Works* v. *Commissioner*, 182 F. 2d 526 (C. A. 9th); *American Brewery* v. *United States*, 223 F. 2d 43 (C. A. 4th).

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missioner, 28 B. T. A. 244 (payment of a state penalty tax); *Dorchester, Inc.* v. *Commissioner*, 12 T. C. 958 (payment of "liquidated damages" for child labor violations); *Boyle, Flagg & Seaman, Inc.* v. *Commissioner*, 25 T. C. 43 (payments in violation of state insurance laws); *Great Northern Ry Co.* v. *Commissioner*, *supra*, and *Terminal Railroad Assn. of St. Louis* v. *Commissioner*, *supra* (penalties paid for violation of federal statutes pertaining to the operation of railroads); *Burroughs Bldg. Material Co.* v. *Commissioner*, 47 F. 2d 178 (C. A. 2d) (fines incurred as the result of the violation of state price-fixing laws); *United States* v. *Jeffray*, 97 F. 2d 188 (C. A. 8th), affirmed on other issues, *sub nom. United States* v. *Bethlehem & Petrosia Co.*, 306 U. S. 276 (penalty paid in civil action for negligent understatement of taxes); *Standard Oil Co.* v. *Commissioner*, 129 F. 2d 363 (C. A. 7th), certiorari denied, 317 U. S. 688 (damages paid to the Federal Government for illegal conversion of oil lands brought about by corruption (bribery)); *Helvering* v. *Superior Wines & Liquors*, 134 F. 2d 373 (C. A. 8th) (amounts paid in compromise of liabilities for violation of federal taxing statutes); *Commissioner* v. *Longhorn Portland Cem. Co.*, 148 F. 2d 276 (C. A. 5th) certiorari denied, 326 U. S. 728, and *Universal Atlas Cement Co.* v. *Commissioner*, 9 T. C. 971, affirmed, *per curiam*, 171 F. 2d 294 (C. A. 2d)

In *Commissioner* v. *Heininger, supra,* 320 U. S. at 473, footnote 8, this Court referred to a related group of cases in which the courts, for public policy reasons, have denied deductions as a matter of law: "A taxpayer who has been prosecuted under a federal or state statute and convicted of a crime has not been permitted a tax deduction for his attorney's fee." (citing *Estate of Thompson* v. *Commissioner*, 21 B. T. A. 568, appeal dismissed, 62 F. 2d 1082 (C. A. 8th), and *Burroughs Bldg. Material Co.* v. *Commissioner*, 47 F. 2d 178 (C. A. 2d)). This result was reached by "the clearest analogy" to the cases holding that fines and penalties paid for the commission of unlawful acts are not deductible as ordinary and necessary expenses. *Levinstein* v. *Commissioner*, 19 B. T. A. 99, 104–105. The courts have uniformly denied deductions for fees paid for the unsuccessful defense of criminal charges not only in cases where the taxpayers' enterprises were illegal, but also where

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certiorari denied, 336 U. S. 962 (amounts paid in compromise of penalties for alleged violation of state anti-trust laws); *Lustig* v. *Commissioner*, 226 F. 2d 695 (C. A. 7th), certiorari denied, 350 U. S. 934; *Henry Watterson Hotel Co.* v. *Commissioner*, 15 T. C. 902, affirmed, *per curiam*, 194 F. 2d 539 (C. A. 6th); *Garibaldi & Cuneo* v. *Commissioner*, 9 T. C. 446; *Scioto Position Co.* v. *Commissioner*, 9 T. C. 439; and *New Orleans Motor Co.* v. *Commissioner*, decided June 30, 1949 (1949 P-H T. C. Memorandum Decisions, par. 49,173) (payments to the United States for overcharges made in violation of the Emergency Price Control Act of 1942); *Hoover Motor Express Co., Inc.* v. *United States*, 241 F. 2d 459 (C. A. 6th), pending on writ of certiorari in this Court, No. 95, this Term, and *Tank Truck Rentals, Inc.* v. *Commissioner*, 242 F. 2d 14 (C. A. 3d), pending on writ of certiorari in this Court, No. 109, this Term (penalties for violations of state weight limitation laws).

the businesses, though lawful, were unlawfully conducted.[5]

In still another group of cases, the courts have denied deductions, as a matter of law, for excessive wages paid in violation of certain federal legislation and regulations thereunder. In *Pedone* v. *United States*, 151 F. Supp. 288 (C. Cls.), *Solon Decorating Co.* v. *Commissioner*, decided February 28, 1957 (1957 P-H T. C. Memorandum Decisions, par. 57,035), and *Zelman* v. *Commissioner*, 27 T. C. 876 (the two latter cases pending on appeal in the Sixth Circuit), deductions were denied for wage payments in violation of the Defense Production Act of 1950; see also, *National Enforcement Commission* v. *Slim Olson, Inc.*, 221 F. 2d 92 (C. A. D. C.). In *Weather-Seal Mfg. Co.* v. *Commissioner*, 16 T. C. 1312, affirmed, *per curiam*, 192 F. 2d 376 (C. A. 6th); *N. A. Woodworth Co.* v. *Kavanaugh*, 102 F. Supp. 9 (E. D. Mich.), affirmed, *per curiam*, 202 F. 2d 154 (C. A. 6th); *Binder* v. *Commissioner*, decided May 27, 1953 (1953 P-H T. C. Memorandum Decisions, par. 53,183); and *Gilmore* v. *United*

[5] See, in addition to the other decisions cited above, *Backer* v. *Commissioner*, *supra*; *Lindheim* v. *Commissioner*, 2 B. T. A. 229; *Wolf Manufacturing Co.* v. *Commissioner*, 10 B. T. A. 1161; *Atlantic Terra Cotta Co.* v. *Commissioner*, 13 B. T. A. 1289; *Sanitary Earthenware Specialty Co.* v. *Commissioner*, 19 B. T. A. 641; *Estate of MacCrone* v. *Commissioner*, decided August 26, 1955 (1955 P-H T. C. Memorandum Decisions, par. 55,238), vacated and remanded, 240 F. 2d 841 (C. A. 3d); *Stralla* v. *Commissioner*, 9 T. C. 801; *Thomas* v. *Commissioner*, 16 T. C. 1417; *Joseph* v. *Commissioner*, 26 T. C. 562; *Union Packing Co.* v. *Commissioner*, decided November 22, 1955 (1955 P-H T. C. Memorandum Decisions, par. 55,308); *Commissioner* v. *Longhorn Portland Cem. Co.*, *supra*; *Commissioner* v. *Schwartz*, 232 F. 2d 94, 99 (C. A. 5th).

States, 131 F. Supp. 581 (N. D. Cal.), deductions were denied for wages paid in violation of the Stabilization Act of 1942. And in the *Pedone* case, *supra*, the Court of Claims, in sustaining the Government's denial of a deduction for "payments made in violation of law or public policy," said (p. 292):

> If it could not do so, it would find itself in the position of subsidizing the violation of its law or public policy, since a percentage of the improper payment, depending on the tax bracket of the taxpayer, would be recovered by him in the form of a reduction of his income tax.

For similar reasons, deductions have been denied for payments made by corporate officers or directors to their companies in reimbursement of profits realized under circumstances covered by Section 16 (b) of the Securities Exchange Act of 1934, c. 404, 48 Stat. 881. *Davis* v. *Commissioner*, 17 T. C. 549; *Dempsey* v. *Commissioner*, decided September 28, 1951 (1951 P-H T. C. Memorandum Decisions, par. 51,281); *Lehman* v. *Commissioner*, 25 T. C. 629.

Considerations of public policy have also resulted in denying deductions on account of bribes paid by bootleggers, and payments made in response to commercial extortion.[7] Deductions for "commissions" paid to

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[7] See *Clark* v. *Commissioner*, 19 T. C. 48; *Lafayette Corp.* v. *Commissioner*, 33 B. T. A. 1158; *Newman* v. *Commissioner*, decided August 29, 1952 (1952 P-H T. C. Memorandum Decisions, par. 52,267); *Maddas* v. *Commissioner*, 40 B. T. A. 572, affirmed, 111 F. 2d 548 (C. A. 3d); *Kelley-Dempsey & Co.* v. *Commissioner*, 31 B. T. A. 351; *Reliable Milk & Cream Co.* v. *Commissioner*, decided August 20, 1938 (1938 P-H B. T. A. Memorandum Decisions, par. 38,290); cf. *United States* v. *Sullivan*, *supra*, 274 U. S. at 264.

persons for their use of personal influence in obtaining public contracts have been denied as against public policy (*Harden M. Loan Co.* v. *Commissioner*, 137 F. 2d 282 (C. A. 10th); *Rugel* v. *Commissioner*, 127 F. 2d 393 (C. A. 8th); *Easton Tractor & Equipment Co.* v. *Commissioner*, 35 B. T. A. 189; *Nicholson* v. *Commissioner*, 38 B. T. A. 190; *Finley* v. *Commissioner*, 27 T. C. 413); and so, too, have such a miscellany of expenditures as payments by abortionists to procurers and assistants (*Giubbini* v. *Commissioner*, decided October 27, 1939 (1939 P–H B. T. A. Memorandum Decisions, par. 39,471); *Estate of Karger* v. *Commissioner*, decided July 13, 1954 (1954 P–H T. C. Memorandum Decisions, par. 54,204); fees paid for membership identification tags on pinball machines where the purpose of the association was illegal (*Fazzio* v. *Commissioner*, decided September 7, 1943 (1943 P–H T. C. Memorandum Decisions, par. 43,410)); and payments for whiskey used for entertainment purposes by a legitimate business where it was unlawful under state law to purchase, give away, or furnish alcoholic beverages (*Finley* v. *Commissioner*, *supra*).

As already noted, this Court has refused to permit any deduction for lobbying expenditures incurred in order to procure legislation. *Textile Mills Corp.* v. *Commissioner*, *supra*.[10] Although the nondeductibil-

[10] See also, *Sunset Scavenger Co.* v. *Commissioner*, 84 F. 2d 453 (C. A. 9th); *American Hardware & Eq. Co.* v. *Commissioner*, 202 F. 2d 126 (C. A. 4th); *Roberts Dairy Co.* v. *Commissioner*, 195 F. 2d 948 (C. A. 8th), certiorari denied, 344 U. S. 865; *McClintock-Trunkey Co.* v. *Commissioner*, 19 T. C. 297, reversed on other grounds, 217 F. 2d 329 (C. A. 9th);

ity of lobbying and related expenditures has been covered by successive Treasury Regulations,[11] the regulation in *Textile Mills* did not constitute an exclusive application of the public policy considerations on which it rested. In the nature of things, such a regulation could be no more than illustrative; the Commissioner cannot attempt to promulgate Regulations to fit precisely every factual situation to which the tax laws apply. *Welch* v. *Helvering*, 290 U. S. 111, 115. The significance of *Textile Mills* is that it necessarily recognizes that considerations of public policy are properly taken into account in construing Section 23 (a) (1) (A)[12]—a conclusion strongly fortified by this

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Mosby Hotel Co. v. *Commissioner*, decided October 22, 1954 (1954 P-H T. C. Memorandum Decisions, par. 54,288); *Revere Racing Assn.* v. *Scanlon*, 137 F. Supp. 293 (D. Mass); *Cammarano* v. *United States* (C. A. 9th), decided July 8, 1957 (57-2 U. S. T. C., par. 9825).

[11] Treasury Regulations 118, Sections 39.23(o)-1(f) and 39.23(q)-1(a); Treasury Regulations 111, Sections 29.23(o)-1 and 29.23(q)-1; Treasury Regulations 103, Sections 19.23 (o)-1 and 19.23 (q)-1. For prior administrative provisions, see *Textile Mills Corp.* v. *Commissioner*, *supra*, 314 U. S. at 337-338.

[12] Tax benefits, other than deductions for "ordinary and necessary" expenses under Section 23(a)(1)(A), have been denied on considerations of public policy. See, *e. g.*, *Turnipseed* v. *Commissioner*, 27 T. C. 758 (dependency exemption under Sections 151 (e)(1) and 152 (a)(9) of the Internal Revenue Code of 1954 denied for a member of the taxpayer's household with whom he lived in adultery, in violation of the laws of the State of Alabama); *United States* v. *Algemene Kunstzijde Unie, N. V.*, 226 F. 2d 115 (C. A. 4th), certiorari denied, 350 U. S. 969 (deduction under Section 23 (f) of the Internal Revenue Code of 1939 denied to a foreign corporation doing business in this country for loss incurred when certain of its assets were vested by the United States under the Trading with the Enemy Act); and *Fuller* v. *Commis-*

Court's subsequent observations in the *Heininger* and *Lilly* cases, *supra*. The many cases interpreting the statute as not authorizing deductions for illegal expenditures or those occasioned solely by the taxpayer's illegal conduct, clearly demonstrate the long-standing construction which the statute has been given. That construction is entitled to great weight, particularly in view of the successive reenactments of the statute employing the phrase "ordinary and necessary." Cf. *Corn Products Co.* v. *Commissioner*, 350 U. S. 46, 53; *Helvering* v. *Winmill*, 305 U. S. 79, 83; *Commissioner* v. *Hunter*, 331 U. S. 210, 214–215.

2. SPECIFICALLY, THE EXPENDITURES HERE ARE NOT DEDUCTIBLE BECAUSE THEY WERE INDEPENDENTLY ILLEGAL UNDER ILLINOIS LAW AND WERE MADE TO INDUCE OTHERS TO COMMIT CRIMES

The payments here are "rent" and "wages" paid in Illinois by bookmakers. The "rent" consisted of payments made by Sullivan and Ross to a downtown Chicago hotel for permission to use various rooms on its upper floors for the gambling operation. The "wages," paid by all of the taxpayers, were paid to other individuals for working in the bookmaking establishments. These payments were in themselves illegal, and hence not "ordinary and necessary".

Under Section 336 of the Illinois Criminal Code, *supra*, p. 3, any person "who records or registers bets or wagers" is guilty of a crime. Under the same section any person who "being the owner * * *

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sioner, 213 F. 2d 102 (C. A. 10th) (deduction under Section 23 (e) of the Internal Revenue Code of 1939 denied for loss incurred when whiskey, being sold in a dry state, was confiscated by law enforcement officers).

of any room * * * or building * * * knowingly permits the same to be used" for gambling purposes is also guilty of a crime. It is this statute upon which we rely in contending that the payments here sought to be deducted are different from other payments which the taxpayers might make. The payments here in question are not illegal simply because the taxpayers are engaged in an illegal enterprise. When a bookmaker buys paper or pencils, or gasoline for his car, it is not necessarily an illegal transaction.

But the Illinois statute specifically makes it a crime to record wagers and knowingly to allow rooms to be used for bookmaking. Thus the payments which the tapayers seek to deduct are ones made to induce other persons to commit violations of state law. These payments are illegal not because the tapayers are engaged in illegal activities but because these payments were made for the purpose of bringing about additional crimes. There is no showing that the amounts paid were calculated as normal room rentals rather than at some higher rate to compensate for the criminal conduct being induced. And whatever the rate, it is clear that it was not a normal rental transaction. The owner was not being paid just to rent a room; he was being paid to commit a crime.

It may be that there are expenses which in themselves are lawful and are "ordinary and necessary" to the bookmaking activities of the taxpayers, and hence are properly deductible against their income.[13]

[13] There is a question whether Congress intended the words "trade or business" as used in Section 23 (a) (1) (A) to refer to illegal enterprises. See Baker, *The Federal Taxing Power and*

But the expenses here could not so qualify. It is not "necessary" to induce others to join them in their criminal undertaking. Paying someone else to commit a crime is a crime. Payments of the kind here involved, made to other persons for the purpose of inducing them to commit crimes, are illegal under Illinois law, independent of the fact that the persons making the payments were engaged in an illegal activity.

This is clear from the Tax Court's findings. In the *Sullivan* and *Ross* cases the Tax Court found that the (R. 11) "services of the employees for * * * wages were performed in the illegal operation" of the enterprise, and the same conclusion is implicit in its detailed findings in the *Mesi* case (R. 83–85). In the

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Organized Crime, Wash. U. L. Q. 121, 140–146 (1953); *Humphreys* v. *Commissioner*, 125 F. 2d 340, 343 (C. A. 7th), certiorari denied, 317 U. S. 637; *Walsch* v. *Call*, 32 Wis. 159. Cf. S. Rep. No. 781, 82d Cong., 1st Sess., p. 120 (1951–2 Cum. Bull. 458, 544), where a proposal for legislation specifically disallowing any expenses incurred in illegal wagering and any losses resulting from illegal wagering was considered as requiring "additional time * * * for detailed study." But resolution of the question is not necessary here. It may be assumed, *arguendo*, that some expenditures of an illegal enterprise are "legitimate" expenses and, therefore, deductible (*Comeaux* v. *Commissioner*, 10 T. C. 201, 207, affirmed, *sub nom. Cohen* v. *Commissioner*, 176 F. 2d 394, 400 (C. A. 10th); *Silberman* v. *Commissioner*, 44 B. T. A. 600, 603–604)—and perhaps that is what this court implied in stating (*Commissioner* v. *Heininger*, 320 U. S. at 474) that it has "never been thought * * * that the mere fact that an expenditure bears a *remote* relation to an illegal act makes it non-deductible." (Emphasis supplied.) However, the payments of rents and wages in the instant cases obviously bear no mere remote relation to illegal acts; on the contrary, they were found to be, in themselves, illegal acts under the Illinois statutes and so clearly fall outside the category suggested in the *Heininger* case.

Sullivan and *Ross* cases the Tax Court also found that the (R. 11) "lessor knowingly permitted these rooms to be used for the purposes of bookmaking." There was thus full warrant for its findings in all of the cases that the acts performed by the employees in return for the wages, and by the lessor in return for the rents, "constituted violations of section 336 of the Criminal Code of the State of Illinois." (R. 11, 86.)

Section 582 of the Illinois Criminal Code, which must be read in connection with Section 336, provides, among other things, that one who "aids, abets, assists, advises or encourages" the perpetration of a crime "shall be considered as principal, and punished accordingly." The payment of wages to induce the employees in all of the cases below to commit the crime of registering wagers on horse races, and the payment of rents to induce the lessor in the *Sullivan* and *Ross* cases to commit the crime of knowingly permitting the premises to be used for the condemned purposes, plainly constituted such encouragement and aid in the illegal activities of those persons as to make the taxpayers, by virtue of the payments, accessories to the crimes committed by the payees and, therefore, punishable as principals. The Tax Court in effect so found. (R. 15, 93.) [14] See also, *McGrath* v. *Commissioner*, 27 T. C. 117, 131–132; and *English* v. *Commissioner*, decided November 16, 1956 (1956 P-H T. C.

[14] Moreover, in making the payments of rents and wages and thus inducing the payees to violate Section 336 of the Criminal Code of Illinois, the taxpayers also appear to have been conspirators, within the meaning of Sections 139 and 140 of the Illinois Revised Statutes (1945), c. 38 (Criminal Code).

Memorandum Decisions, par. 56,254). In making these payments, the taxpayers thus contravened state policies "evidenced by some governmental declaration of them" (*Lilly* v. *Commissioner, supra*, 343 U. S. at 97), since the public policy of a state is of course declared in its statutes (*Colgrove* v. *Lowe*, 343 Ill. 360).

II. THE TAXPAYERS' ARGUMENTS IN SUPPORT OF DEDUCTIBILITY ARE WITHOUT MERIT

The taxpayers make several arguments as to why the general rule forbidding deduction of illegal expenditures should not be applied here. None, we submit, has any substance.

1. THE FACT THAT "RENTALS" AND "SALARIES" ARE MENTIONED IN SECTION 23(a) DOES NOT EXCUSE SUCH EXPENSES FROM THE REQUIREMENT THAT THEY MUST ALSO BE "ORDINARY AND NECESSARY"

Under Section 23 (a) (1) (A) there are allowed as deductions in computing net income—

> All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * * and rentals or other payments required to be made as a condition to the continued use or possession * * * of property * * *.

No expense may be deducted under Section 23 (a) (1) (A) unless it is ordinary and necessary. *Welch* v. *Helvering*, 290 U. S. 111. The fact that the statute indicates that such expenses include "a reasonable allowance for salaries or other compensation for personal services actually rendered" does not mean that

such expenses are *always* ordinary and necessary, as a matter of law and without regard to the facts of the particular case. Congress has not declared that all compensation for services rendered is automatically deductible. The expense must also be ordinary and necessary.

It is plain from the language of Section 23 (a) (1) (A) that the clauses dealing with compensation and with rentals were inserted as limitations on, not as exceptions from, the requirement that they be "ordinary and necessary." Compensation must not only be ordinary and necessary but is further limited by the requirement that it be a "reasonable" allowance and that it be paid for "services actually rendered." Rentals similarly are limited so that they must not only be ordinary and necessary but also must be for the continued use of property "for purposes of the trade or business," and the property must be one in which the taxpayer has neither equity nor title interest.

In any event, the cases clearly establish that the test of "ordinary and necessary" applies to compensation for personal services as well as other types of expenditures. In their brief in opposition the taxpayers recognize (p. 5) that "courts have permitted consideration of the 'public policy' issue" when considering deductions for "bribes" and for "defense of fraud charges." Illustrations of such instances are contained in the Court's opinion in the *Heininger* case, 320 U. S. at 473–474. The courts have uniformly denied deductions for personal compensation paid for the unsuccessful defense of criminal charges

not only in cases where the taxpayers' enterprises were illegal, but also where the businesses, though lawful, were unlawfully conducted.[7] They have also denied deductions for salaries paid in excess of wage ceilings established by federal legislation.[8] Thus, the fact that rents and personal compensation are mentioned in Section 23 (a) (1) (A) in no way relieves such payments from the requirement of "ordinary and necessary."

2. THE FAILURE OF CONGRESS TO IMPOSE A GROSS INCOME TAX ON ILLEGAL WAGERING IN 1951 SHEDS NO LIGHT ON THE DEDUCTIBILITY UNDER THE 1939 CODE OF PAYMENTS WHICH ARE INDEPENDENTLY ILLEGAL

The taxpayers' second argument is (Br. in Opp. 6-9) that Congress has manifested an intent that gamblers be allowed to deduct all of their expenditures under Section 23 (a). The argument has two underlying assumptions, both of which are invalid. The first is that because Congress taxed gains, profits and income derived from illegal activities, it necessarily intended to permit deduction of all expenses incurred in connection therewith. The short answer, however, is that by its very terms Section 23 (a) (1) (A) restricts deductions to those expenses which are "ordinary and necessary," and expenditures—such as those here involved—made to induce others to commit crimes under state law are not "ordinary and necessary."

The second assumption is that, in failing in 1951 to enact into law Senator Kefauver's proposal that

[7] See cases cited at pp. 21-22, *supra*.

[8] See cases cited at pp. 22-23, *supra*.

no deduction shall be allowed for any expense paid or incurred in carrying on illegal wagering. Congress manifested an intent to permit deduction of all expenses in connection with that activity. The conclusion is a *non sequitur*. The failure of Congress in 1951 to impose a gross income tax on illegal wagering does not manifest its intent, in enacting the 1939 Code, with respect to the deductibility of payments which in themselves are unlawful. Moreover, the Senate committee report on the Kefauver proposal stated only that "additional time is necessary for detailed study of these suggestions and therefore * * * action on them should not be taken at this time." S. Rep. No. 781, 82d Cong., 1st Sess., p. 120 (1951–2 Cum. Bull. 458, 514). As the debate on the proposal amply demonstrates (97 Cong. Record, Part 9, pp. 12230–12244), far more was involved in Senator Kefauver's proposed amendment than the disallowance of all expenses paid or incurred in connection with illegal wagering. The proposed amendment was part of a legislative package, containing, in addition to the provision against deduction of all expenditures, provisions also for the maintenance and inspection of the records of wagering houses, for the filing of net worth statements by all individuals with gross income over $10,000 earned from one or more unlawful businesses, and for the preservation of records for a period of seven years after the date of the transactions to which they related. The Senate's rejection of the Kefauver proposal was at best equivocal, and affords no support for the sweeping inferences drawn by the taxpayers.

3. TO DISALLOW THESE DEDUCTIONS WOULD NOT RESULT IN IMPOSING A "DISCRIMINATORY" GROSS INCOME TAX ON GAMBLERS

The taxpayers suggest (Br. in Opp. 9–12) that if they are not allowed to deduct the payments here involved, the income tax will, as to them, become a tax on gross income. They say that, since this business is illegal, "all its expenses are illegal * * * because they are incurred in the carrying on of an illegal business." (Br. in Opp. 12.) But we do not contend that the rule is different as to illegal businesses from what it is for others. If a legitimate business pays a person to commit a crime, such payment is not deductible. If an illegal business pays a person to commit a crime, that, too, is nondeductible. Thus, if taxpayers are right, an illegal enterprise would obtain favored tax treatment because it is illegal—a result hardly intended by Congress.

There is no basis in principle for any distinction between the instant case and the many decisions in which deductions have been denied for certain expenditures made in connection with other illegal activities, bribes paid to public officers, wages paid in violation of federal statutes, fines and penalties paid for violation of federal and state statutes, payments for lobbying and political pressure activities, and the like. Here the expenditures were made to induce others to commit offenses; the making of the expenditures constituted crimes under Illinois law. A gambler's net income is taxed on the same basis as any other person's. When a particular payment or expense is illegal, such payment is not deductible, whether made by a legitimate or illegitimate business. Certainly,

the statute should not be construed to confer a tax benefit on those engaged in an illicit enterprise as against those engaged in a lawful business. For it is certainly settled that the latter cannot deduct expenses for commission of crimes.

4. THE "INTEGRALITY" TEST IS UNSUPPORTABLE UNDER THE STATUTE

In attempting a rationalization for treating the payments here involved differently from other types of admittedly nondeductible illegal expenditures, the decisions below rest upon the Seventh Circuit's characterization of the rents and wages paid under similar circumstances in the *Doyle* case, *supra*, as "integral." The concept advanced is that expenditures are deductible, no matter how illegal they may be,[17] provided they are "economically * * * an integral part of a business" while those which are only "concomitants to the business" are not deductible. *Commissioner* v. *Doyle*, 231 F. 2d 635, 637. "In this [latter] class", the Seventh Circuit stated, "fall bribes paid to public officers, fines and penalties imposed for violations of federal or state statute, expenses for certain types of lobbying and political pressure activities, payments to an influential party precinct captain, in order to obtain a state printing contract and other similar disbursements." (*Id.* at 637.)

[17] The Tax Court in *Doyle* v. *Commissioner*, decided December 27, 1954 (1954 P-H T. C. Memorandum Decisions, par. 54,340), made no findings, as it did in the instant cases, that the payments of rents and wages were, in themselves, offenses under state law. On the contrary, it concluded that the taxpayer was entitled to deduct the amounts of rents and wages on the authority of *Stralla* v. *Commissioner*, *supra*, and

The distinction between "integral" and "concomitant" business expenses is difficult to grasp.[7] For example, if state contracts can be obtained only by bribes or by payments to influential politicians, a taxpayer might not obtain business except by making the payments. In such circumstances, the payments would seem to be an "integral" rather than "concomitant" part of the business activity. *E. g., Rugel* v. *Commissioner, supra; Harder M. Loan Co.* v. *Commissioner, supra; Nicholson* v. *Commissioner, supra; Easton Tractor & Equipment Co.* v. *Commissioner, supra.* Similarly, payments to racketeers (*Reliable Milk & Cream Co.* v. *Commissioner*), decided August 20, 1938 (1938 P-H B. T. A. Memorandum Decisions, par. 38,290), amounts paid as commer-

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Corcoran v. *Commissioner, supra*, 10 T. C. at 207, in which it said it had "considered the question of whether the *legitimate* expenses of an illegitimate business constituted allowable deductions for income tax purposes and concluded that they did." (Emphasis supplied.) The opinion of the Court of Appeals in the *Doyle* case, Appendix, *infra*, pp. 39-46, while making a passing reference to the Commissioner's insistence upon including "the element of lawfulness of expenses of rent and salaries of a trade or business as a requirement for their deductibility," in substance rested on the proposition that "integral" expenses should not be denied, even though the business in which they were incurred was unlawful. Cf. the Seventh Circuit's statement in the *Sullivan* and *Ross* cases (R. 22): "Our opinion in the *Doyle* case neither expressly treated, nor by any possible inference can be construed as treating, the wages and rents paid by the taxpayer as 'legitimate' expenses."

[7] The distinction appears to have been ignored by the Seventh Circuit in its prior decisions in *Leidig* v. *Commissioner*, 223 F. 2d 695, certiorari denied, 350 U. S. 934; *Standard Oil Co.* v. *Commissioner, supra*; and *Humphreys* v. *Commissioner*, 125 F. 2d 349, certiorari denied, 317 U. S. 637.

cial extortion; *(Kelley-Dempsey & Co. v. Commissioner*, 31 B. T. A. 351), payments by abortionists to assistants and procurers (*Giubini v. Commissioner, supra; Estate of Karger v. Commissioner, supra*); and payments of fines and penalties, even for violations unavoidable in the conduct of business (*Great Northern Ry. Co. v. Commissioner, supra; Terminal Railroad Assn. of St. Louis v. Commissioner, supra*)—all of which the Seventh Circuit would presumably classify as "concomitant"—are probably realistically regarded as "integral" aspects of those businesses. In *Textile Mills, supra*, in which the compensation paid by a corporation to a publicist and two legal experts would be "concomitant" under the *Doyle* test, it was conceded that those expenses were (38 B. T. A. 623, 627) "in fact ordinary and necessary in performing the services required of it under its contract" to procure the enactment of certain legislation.[10]

Apart from being unrealistic and unworkable, the "integral" test is, in any event, irreconcilable with the [illegible] and the many decisions holding that the standard of "ordinary and necessary" precludes allowance of those expenditures which "frustrate sharply defined national or state policies proscribing particular types of conduct," if the policies are "evidenced by some governmental declaration of them." *Lilly v. Commissioner, supra*, 343 U. S. at 95-97. A payment made for commission of a crime, or to [illegible]

[10] "If this Court had in *Textile Mills* taken the same view of the 'ordinary and necessary' clause of Section 23 (a) as the Seventh Circuit, it would have held Article 262 of Treasury Regulations 74 to be in conflict with the statute and invalid.

ter how "integral" it is in the carrying out of the business in which a taxpayer is engaged, could not have been regarded by Congress as "ordinary and necessary". In our society, and in any civilized society, it is not "ordinary and necessary" to commit crimes—and if Congress had legislated in the income tax laws on a contrary assumption, there would surely have been some indication to that effect in the language and history of the legislation. There is none.

CONCLUSION

The judgments of the court below should be reversed.

Respectfully submitted.

J. LEE RANKIN,
Solicitor General.
CHARLES K. RICE,
Assistant Attorney General.
JOSEPH F. GOETTEN,
MEYER ROTHWACKS,
Attorneys.

SEPTEMBER 1957.

APPENDIX

In the United States Court of Appeals for the Seventh Circuit

No. 11572. October Term, 1955, January Session, 1956

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CHARLES V. DOYLE AND CLARA DOYLE, RESPONDENTS

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

April 11, 1956

Before MAJOR, FINNEGAN and SCHNACKENBERG, *Circuit Judges*

SCHNACKENBERG, *Circuit Judge*.

This petition for review involves income taxes and penalties of $7,223.75 for 1948, 1949 and 1950, and questions the correctness of a decision of the Tax Court entered on January 26, 1955. The petition was filed by the Commissioner on April 25, 1955, pursuant to sec. 7482 of the Internal Revenue act of 1954.[1]

As expressed in the words of the Commissioner, the question presented is whether expenses for rent and wages incurred in the operation of an illegal gambling business are themselves contrary to a sharply defined and declared public policy of the state of Illinois and hence are not deductible for income tax purposes,

[1] 26 U. S. C. A. § 7482.

within the meaning of sec. 23 (a), Internal Revenue Code of 1939.[2]

During the taxable years, the taxpayer, Charles V. Doyle, hereinafter referred to as respondent,[3] was engaged in accepting wagers on horse races, herein referred to as bookmaking or operating a handbook, in the state of Illinois. Respondent paid rent for a room in Chicago where he accepted, recorded and paid the wagers. In the conduct of this business respondent paid wages to several employees.

The Commissioner contends that the Tax Court erred in allowing these amounts to be deducted from the gross income of the respondent.

The blueprint for this decision is to be found in sec. 23 of the Internal Revenue Code of 1939.[4] Relevant provisions thereof read as follows:

> § 23. Deductions from gross income.
>
> In computing net income there shall be allowed as deductions:
>
> (a) [as amended by Sec. 121 (a), Revenue Act of 1942, c. 619, 56 Stat. 798]. *Expenses.*
>
> (1) *Trade or business expenses.*
>
> (A) *In general.* All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * * and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

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[2] 26 U. S. C. A. § 23 (a).

[3] Clara Doyle is a party by reason of filing joint returns with her husband, the respondent. She will not be further referred to in this opinion.

[4] 26 U. S. C. A. § 23.

Sec. 23 (a), in setting forth what trade or business expenses are to be deducted from gross income in computing net income, makes no distinction between lawful and unlawful disbursements. The act says that there shall be allowed as deductions all ordinary and necessary expenses paid or incurred in carrying on any trade or business, including a reasonable allowance for salaries and rentals for use of property for purposes of the trade or business.

Both parties agree that gross income includes income from a trade or business regardless of its lawfulness or unlawfulness. But the Commissioner would include the element of lawfulness of expenses of rent and salaries of a trade or business as a requirement for their deductibility, in addition to the act's requirement that said expenses be "ordinary and necessary". Here is "clear Congressional action" contrary to the Commissioner's position. *Textile Mills Securities Corp.* v. *Commissioner*, 314 U. S. 326, at page 328, 62 S. Ct. 272, 86 L. Ed. 249. The Commissioner would have us add the word "lawful" in the guise of judicial construction. This is a taxing statute. The congress by this act purposed the raising of revenue rather than the furnishing of aid to the enforcement of the state's criminal laws. In imposing an income tax, the congress draws no distinction between income from a lawful business and income from an unlawful business. It is not concerned with the source.

The language of sec. 23 is clear and unambiguous. Its application to this case requires an affirmance of the Tax Court's decision. However, because of the exhaustive brief filed by the Commissioner, in which he attempts to justify his contention that the Tax Court erred, we shall not end this opinion at this point; but shall discuss the Commissioner's argu-

ments and the principal cases upon which he relies.

In the situation in which we find ourselves, we have no right to let our natural antipathy to respondent, because of the unlawfulness of his business, deter us from objectively applying the law as it is written. Lawful or unlawful, the government has seen fit to impose a tax upon respondent's business. That business, like most businesses, has intake and out-go. The Commissioner would have us consider that business as divided into three parts: (1) the gross income, (2) the amounts paid for salaries and rent, and (3) other expenses of the business. As we shall see, the Commissioner, in computing respondent's income tax, takes into account (1) and (3) and discards (2). This is confusing because (2) is expressly recognized as a proper deduction by sec. 23 (a), and (3) is also recognized, but not specifically. However the business is not susceptible to the assumed division. The business, whose income the government seeks to tax, is a unit. Its income is as unlawful as any of its ordinary and necessary expenses. They are all integral parts of a whole tree whose fruit the Commissioner would tax. He is inconsistent when he concedes that the following expenses in part (3) are deductible: lights, forms and scratch sheets, repairs, supplies, telephone, wall sheets, armored express, wire service, safety tickets, depreciation, auditing, currency exchange, stationery and printing, laundry, etc., totalling for 1948, $6,903.53, for 1949, $6,615.59, and for 1950, $6,357.43.

From sec. 23 (a) we find that an allowable deduction claimed for an expense in carrying on a business must be ordinary and necessary, nothing more or less. In what amounts to a partial recognition that this is true, the Commissioner admits as proper deductions respondent's expenses for telephone, printing

and other items, none of them specifically mentioned in the act. It is clear that salaries and rent are ordinary and necessary to the carrying on of the business of a handbook just as the admitted expenses are. Moreover, the act specifically mentions salaries and rent. Economically they are as much an integral part of the business as is the receipt by the handbook operator of moneys paid on bets.

We construe the statutory words "ordinary and necessary expenses" to mean those expenses which economically are an integral part of a business, whether it be lawful or unlawful. Integrality is the test. Disbursements which fail to meet this test, although they may be concomitants to the business as operated by some persons, are not ordinary and necessary expenses thereof within the meaning of sec. 23 (a). We exclude and, therefore, hold as nondeductible, expenses which are not an integral part of a business. In this class fall bribes paid to public officers,[5] fines and penalties imposed for violations of federal or state statute,[6] expenses for certain types of lobbying and political pressure activities,[7] payments to an influential party precinct captain, in order to obtain a state printing contract[8] and other similar disbursements.[9]

As illustrative, we find it helpful to apply the test to two simple situations. An ordinary grocer, who

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[5] *United States* v. *Sullivan*, 274 U. S. 259, 261, 47 S. Ct. 607, 71 L. Ed. 1037.

[6] *Great Northern Ry. Co.* v. *Commissioner*, 8 Cir., 40 F. 2d 372 and *Lentin* v. *Commissioner*, 7 Cir., 226 F. 2d 605.

[7] *Textile Mills Securities Corp.* v. *Commissioner*, 314 U. S. 326, 62 S. Ct. 272, 86 L. Ed. 249.

[8] *Rapid* v. *Commissioner*, 8 Cir., 127 F. 2d 393.

[9] *See Commissioner of Internal Revenue* v. *Heininger*, 320 U. S. 467, 64 S. Ct. 249, 88 L. Ed. 171, affirming this court, 123 F. 2d 567.

bribes a policeman to let him place his wares on a public sidewalk in front of his store in violation of a municipal ordinance, cannot deduct the amount of the bribe as an ordinary and necessary expense of his grocery business. The payment is a concomitant, but not an integral part, of the grocery business. If a handbook operator takes over the store used by the grocer and bribes the same policeman to permit the placing of chairs for the bettors on the same sidewalk in violation of the same ordinance, that payment would for the same reason be nondeductible. The payment is a concomitant, but not an integral part, of the handbook business. Both the grocer and the handbook operator, during their respective occupancies of the store, would be entitled to deduct on their income tax returns expenditures for salaries of clerks, rent of the store and other ordinary and necessary expenses of their businesses, because such payments are an integral part of the business.

To the extent that such ordinary and necessary expenses exist, a holding that they are undeductible by a handbook operator in a state in which the business is unlawful, would mean that such a tax would be levied by the federal government on gross income, while a holding that they are deductible in a state in which the business is lawful, would mean that such a tax would be levied on only net income. We cannot believe that the congress intended this inequitable result. Certainly the clear language of the act does not suggest that such consequences were contemplated by the congress.

Other examples illustrate the fallacy of the Commissioner's contention. Thus one state may prohibit the business of selling automobiles on Sunday, while another may not. Would the Commissioner argue that a dealer who did business on Sunday in the first

state could not deduct from his gross receipts salaries and rent paid for his unlawful activity on that day, while a dealer in the second state could make such deductions? In some areas the sale of intoxicating liquor at retail is legal, and in others it is illegal. Would a retailer's salary and rent payments be deductible or not depending entirely on the lawfulness of his business?

Cases might arise in which the charge of unlawfulness might be denied. In the absence of a criminal trial to resolve the question of the taxpayer's guilt, is that question to be tried by the Commissioner and the Tax Court in tax proceedings? Such a situation might arise from the Commissioner's argument, based on the Illinois statute's provision that an owner, who knowingly permits his property to be used for gambling, shall be subject to punishment, and the further provision that an accessory to the perpetration of a crime shall be punished as a principal. He argues that respondent, in paying rent for his leased handbook premises, is an accessory to the crime of the landlord. If this theory is tenable, someone must determine whether the landlord *knowingly* permitted the illegal use of his premises. Is this question to be determined in a proceeding to which the landlord is not a party? If so, who is to make that determination—the Commissioner and the Tax Court? Those questions are suggestive of the many surprising results which would follow the adoption of the Commissioner's theories. We cannot believe that they were intended by the congress. The clear language of sec. 23 is a bar to such excursions as the Commissioner's contentions would invite.

The Commissioner should have allowed salaries and rent as deductions under sec. 23 (a). Hence the Tax Court's decision is correct and is affirmed.

We feel that it is important to call the attention of the Commissioner to the fact that in this and other cases before us his counsel repeatedly ignore rule 16 (c), (d) and (e), of this court regulating the contents of briefs.

Affirmed.

FINNIGAN, *Circuit Judge* (dissenting).

Book-making is a statutory criminal offense in Illinois. Ill. Rev. Stat. 1955, chap. 38, § 336. It is undisputed that appellee Charles V. Doyle operated "a bookmaking establishment" in that State for the tax years involved. Shortly stated the question is, can Doyle's disbursements for salaries and rents incurred in his illegal enterprise be classed "ordinary and necessary" under § 23 (a) (1), Internal Revenue Code of 1939. Under the Illinois statute Doyle's expense items are unnecessary, though perhaps ordinary. But for deductibility as business expenses in computing federal income taxes, the Congressional mandate requires both elements—ordinary and necessary. I am unable to ignore the public policy of Illinois manifested by its statute proscribing the behavior generating Doyle's items of rent and salaries. The "temerity to raise" such deductibility was long ago anticipated in another case. *United States* v. *Sullivan*, 1927, 274 U. S. 259, 264, 47 S. Ct. 607, 71 L. Ed. 1037. I would reverse the Tax Court decision and remand this case with directions to disallow the deductions claimed.